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IN THE

Supreme Court of the United States

October Term, 1974

No. 74-2731

AFFILIATED FUND, INC., LORD, ABBETT & CO., ROBERT S. DRISCOLL and ALVIN H. BERNDT,
Petitioners,

v.

PAULETTE PAPILSKY,
Respondent.

AFFILIATED FUND, INC., LORD, ABBETT & CO., ROBERT S. DRISCOLL and ALVIN H. BERNDT,
Petitioners,

v.

HARRY LEVINE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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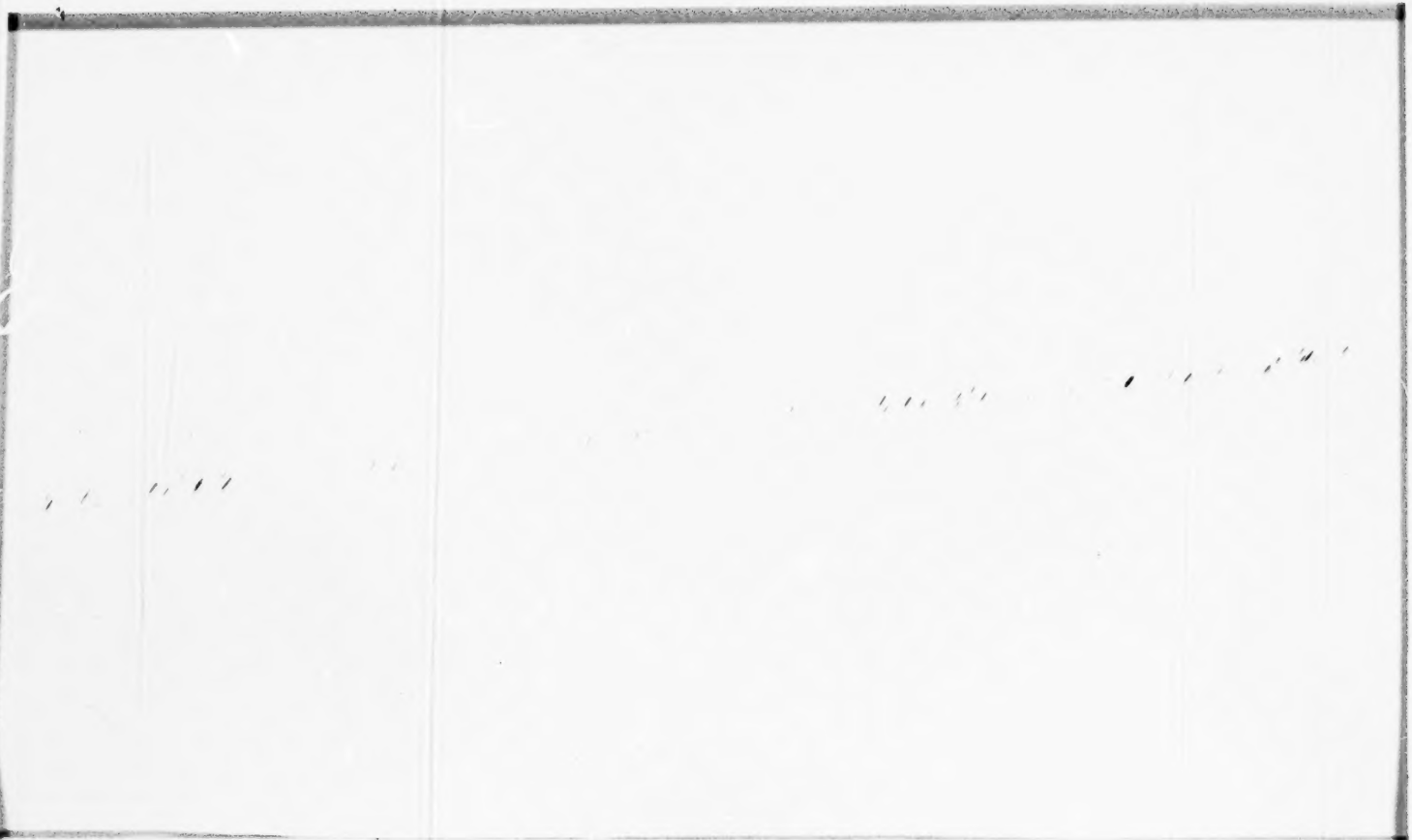

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Affiliated Fund Inc., Lord, Abbett & Co., Robert S. Driscoll and Alvin H. Berndt hereby petition that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered on May 24, 1974 and its orders of August 6, 1974 denying petitions for rehearing and suggestions that such rehearing be held en banc.

OPINIONS BELOW

The per curiam opinion of the Court of Appeals, of which review is sought, has not yet been reported and is printed in the separate Appendix at p. A-40. No opinions were written in support of the orders of that court (printed at A-47) denying rehearing and en banc treatment. The opinion of the United States District Court for the Southern District of New York of March 16, 1973 from which petitioners appealed to the Court of Appeals is reported at 59 F.R.D. 95 and is printed at A-36. At the same time petitioners also appealed from the District Court's unreported order of April 16, 1973 denying their motion for rehearing, which was without opinion and is printed at A-39. Subsequent unreported opinions of the District Court relating in part to issues raised in this petition were entered on July 20, 1973 and January 7, 1974 and are printed respectively at A-50 and A-55.

Earlier proceedings which have no bearing on the present petition include an opinion of the District Court dated November 17, 1971, which is reported at 333 F. Supp. 1084 and printed at A-64, an opinion of the Court of Appeals dated August 1, 1972, which is reported at 466 F.2d 251 and printed at A-72, and a denial by this Court of a petition for a writ of certiorari dated December 18, 1972, reported at 409 U.S. 1077 and printed at A-90.

JURISDICTION

The Judgment of the Court of Appeals for the Second Circuit was entered on May 24, 1974. A timely petition for rehearing, containing a suggestion that the appeals be reheard en banc, was filed on June 7, 1974, and was denied on August 6, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTIONS PRESENTED

1. Should the rule be continued that a minority shareholder may not maintain a derivative action on behalf of his corporation where a majority of the directors, none of whom are self-interested in the transaction complained of, have determined as a matter of business judgment that the action is not in the best interests of the corporation?

2. Where a minority shareholder seeks to bypass the disinterested directors by alleging that they are disqualified by self-interest, may a district court refuse even to consider uncontradicted evidence, including the sworn admissions of plaintiff's counsel, which conclusively demonstrates that the allegations of self-interest are not supported by any evidence?

3. May a district court refuse even to consider such evidence where the allegations so shown to be sham: (a) are contrary to an express presumption of the Investment Company Act that the disinterested directors of an investment company are not controlled; and (b) are designed to disqualify the disinterested directors from performing their statutory duty of regulating the company's relationship with its investment adviser?

4. Are the district court's refusal to consider such evidence and its denial of the corporation's right not to sue appealable before trial under the collateral order doctrine of *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541 (1949) where the right of this nominal defendant cannot be effectively protected or even raised by it in a post trial appeal?

STATUTES AND RULES INVOLVED

The statutes involved are 28 U.S.C. § 1291 and sections 2(a)(3), 2(a)(9), 2(a)(19), 10 and 15 of the Investment Company Act; 15 U.S.C. §§ 80a-2(a)(3), 2(a)(9), 2(a)(19), 10 and 15. Also involved are Rules 11, 23.1 and 41(b) Fed. R. Civ. P. These statutes and Rules are printed in the separate Appendix beginning at A-2.

STATEMENT OF THE CASE

Petitioner Affiliated Fund, Inc., ("Fund"), a Delaware corporation, is an open-end investment company regulated under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80(a) *et seq.* Petitioner Lord, Abbett & Co. ("Lord"), a partnership, is Fund's investment adviser and principal underwriter. Petitioners Driscoll and Berndt are partners of Lord and officers and directors of Fund. Respondents Papilsky and Levine are minority shareholders of Fund who brought these two derivative actions, consolidated below, on behalf of Fund against Fund, a nominal defendant, and the other petitioners. Federal question jurisdiction under 28 U.S.C. § 1331 was asserted on the ground that the complaints alleged causes of action under the Investment Company Act, 15 U.S.C. §§ 80a *et seq.* and the federal securities laws (R13a-30a*).

At all relevant times a majority of Fund's board of directors were not affiliated in any way with petitioners Lord, Driscoll or Berndt and were neither "affiliated persons" nor "interested persons" as defined respectively in Section 2(a)(3) and 2(a)(19) of the Investment Company Act of 1940, as amended (A-4). It is undisputed that under Sections 10 and 15 of the same Act (A-8, A-12) these independent directors have the duty of regulating relationships between Fund and Lord, Driscoll and Berndt. Their jurisdiction includes the right to decide for Fund

* Citations labeled R.. are to the record printed below for the Court of Appeals.

whether suit should be brought against Lord or directors affiliated with Lord.

Section 2(a)(9) of the same Act (A-5) expressly provides that such natural persons "shall be presumed not to be controlled persons," that such presumption may be rebutted by evidence and that except under circumstances not relevant here it shall continue until a determination to the contrary has been made by an order of the Commission. No such order has been entered as to any of Fund's independent directors.

Both of the complaints and the answers raise issues as to the legality of certain practices relating to brokerage commissions. However, in view of the undisputed fact that any trial of the merits would be expensive and protracted and the doubtfulness of the validity of respondents' claims,* it is not surprising that the independent directors believe that it is not in Fund's business interest to pursue the actions.

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* The practices involved brokerage commissions paid for executing Fund's portfolio transactions on national stock exchanges principally during the period before December 1968 when there were no volume discounts from the minimum commissions charged for executing large transactions on such exchanges. During this period exchange members were willing to "give up" large portions of commissions on such transactions to other stock exchange members, and in some instances to certain other broker-dealers, designated by the customer.

No claim is made that any of petitioners pocketed these "give-ups," which were directed to firms who sold Fund shares or who had provided other services to Fund, such as supplying statistical and other information. It is claimed that Lord, Driscoll and Berndt improperly benefited from them indirectly in that Lord's management fee is based upon the net assets of Fund and Lord received portions of the sales charges paid by investors in Fund shares.

However, because Fund, like other open-end investment companies, has a constant stream of redemptions of its shares, sales of Fund shares are necessary to Fund's continued vitality and very existence. Hence, the use of "give-ups" to stimulate sales efforts, like their use to obtain information, benefited all of Fund's shareholders. "Give-ups" were commonly used in the mutual fund industry in this manner.

(*footnote continued on p. 6*)

The principal question litigated below was whether respondent shareholders had standing to bring these actions

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(*footnote continued from p. 5*)

The theory of the complaints is that Lord should have departed from the general industry practice and have "recaptured" the "give-ups" by arranging to become eligible to receive them itself on transactions on certain regional stock exchanges and by crediting them against management fees. Although a few funds experimented with "recapture" before December 1968 when all customer-directed "give-ups" were abolished by exchange rules, there was then no case law approving it. "Recapture" appeared to be contrary to the express language of the rules of the various exchanges which prohibited the granting of indirect rebates of commissions to customers.

The first judicial decision on the subject, which came down long after the abolition of "give-ups", was by Judge Wyzanski in *Moses* v. *Burgin*, 316 F. Supp. 31 (D. Mass. 1970). He held that "recapture" was probably unlawful and that investment advisers such as Lord were therefore not required to engage in it. This remained the only court ruling on the subject until June 4, 1971 when it was reversed in part by the Court of Appeals for the First Circuit, 445 F.2d 369, *cert. denied*, 404 U.S. 994 (1971), which held that such "recapture" was lawful and that affiliated directors who knew that it was readily available had a duty to inform the independent directors of the availability of such "recapture" so that the independent directors could decide whether it should be sought.

No other court has ever ruled on the validity of "recapture" or whether a fund was required to engage in it. Consequently, it is clear that during the period when customer-directed "give-ups" were permitted, "recapture" was of doubtful legal validity. As one writer stated:

> "The problem with a case like *Moses* v. *Burgin* is that when that lawsuit, and others like it, was commenced, except for suggestions in a report such as the one issued by the SEC which does not have the force of law, mutual fund managers had no way of gauging their responsibilities in this complex, largely unchartered field. Before *Moses* v. *Burgin*, a fund manager had no way of knowing for sure that he was required to recapture brokerage in the manner suggested by the Court of Appeals. Beyond that, he had a reasonable fear that if he would attempt recapture in that way he would be violating antirebate rules of particular exchanges." Brodsky, *"Liabilities of Mutual Fund Managers, Corporate and Securities Litigation"*, 167 N.Y.L.J. No. 110, p. 1, p. 3, col. 1 (June 7, 1972).

One of the reasons respondents' claims are of doubtful validity is that it is not likely that a court would hold a fund manager, who fully informed the independent directors, liable for not having experimented with "recapture" in such an unclear legal climate.

over the objection of the independent directors. This involved, among other things, whether respondents had complied with the requirement of Rule 23.1 Fed. R. Civ. P. that they "allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . ., and the reasons for his failure to obtain the action or for not making the effort." (A-3)

No effort was made by either respondent to follow the suggestion of Rule 23.1 that the independent directors be asked to bring the action or be given an opportunity to deal with their claim without litigation. Respondent Papilsky, who filed the first of the instant cases, did not even bother to call the board's attention to the court of appeals decision on which she principally relies* but instead brought suit on the first Monday following the Friday upon which the decision was handed down. Both respondents purported to comply with the Rule by alleging as reasons "for not making the effort" that the independent directors were dominated and controlled by the affiliated directors and that they participated and acquiesced in the alleged wrong and by naming them as additional defendants. These allegations were conclusory and not particularized as required by Rule 23.1**

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* *Moses* v. *Burgin*, see the footnote on p. 5, *supra*.

** Papilsky's complaint alleges:

> "Demand upon the Fund's directors to bring this action would be futile and is unnecessary for at least the following reasons:
>
> "(a) The directors are defendants herein; they participated or acquiesced in the wrongs alleged and are liable therefor;
>
> "(b) The alleged wrongdoers control and dominate the Fund and its board of directors; and
>
> "(c) The institution of the action by the Fund's directors would place it in hostile hands and would prevent its effective prosecution."
>
> * * *

(*footnote continued on p. 8*)

Promptly after the respective complaints were filed, respondents caused process to be served upon Fund, Lord and the affiliated directors but took no steps whatever to cause service to be made on the independent directors who were readily amenable to service (A-60—A-62; A-51—A-53), tactics suggesting that the independent directors were not regarded as real defendants.

When petitioners proposed to serve interrogatories inquiring just what if any basis there was for the allegations concerning these named "defendants", Abraham Pomerantz, Esq., counsel for one of the respondents, suggested that his deposition be taken instead. In his deposition he admitted that neither he nor his client knew anything about the independent directors other than their names and their business affiliations which appeared in Fund prospectuses (R77a). His position was essentially that the business judgment of the independent directors concerning the wisdom of pursuing the alleged corporate claim differed from his own and that this difference alone justified respondents' allegations about the independent directors. Under the circumstances this was tantamount to an admission that there was no basis for the allegations.

Petitioners thereupon moved for orders dismissing the complaints on the ground that in making the conclusory allegations of domination and control without any proper

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(footnote continued from p. 7)

The Levine complaint contains the following substantially similar conclusory allegations:

> "Either the Manager [Lord] has not informed the Fund's directors of the methods by which costs, fees, commissions, and expenses to the Fund could be minimized and that it is the directors' duty to ascertain whether such costs, fees, commissions, and expenses could be reduced, or the directors are so controlled by the Manager that they make no such inquiry or ignore its results."
>
> * * *
>
> "Demand upon the Fund directors to bring this action would be futile, because they have known of, and participated in, the acts complained of, and because control of any action would be in their hostile hands." (R19a and 27a).

basis, respondents failed to comply with: (a) the requirement of Rule 11, Fed. R. Civ. P. that there be "good ground" for a pleading; (b) the requirement of Rule 23.1 that a derivative complaint "shall be verified," and (c) the business judgment aspect of the director demand requirement of Rule 23.1 that the reason for "not making the effort" be particularized. Petitioners also asked that the allegations against the independent directors be stricken under Rule 11 as sham and false.

This motion was supported by an affidavit showing the lack of service on the independent directors, presenting the text of and exhibits to the Pomerantz deposition and demonstrating that the deposition and the materials referred to therein constituted admissions that there was no basis for the attack on the independent directors (R43a). No counter-affidavits or other evidentiary materials were filed in opposition by respondents. They were content with briefs which relied upon the complaints and argued that they alone were enough to require a trial.

Judge Harold Tyler denied these motions. In so doing he refused to consider either petitioners' affidavit or the Pomerantz deposition (R153a, A-35). He also refused to strike any of the allegedly disqualifying allegations, and denied a motion for rehearing and a request that he certify an interlocutory appeal under 28 U.S.C. § 1292(b) (R182a, A-39). Petitioners then took an appeal as of right to the Court of Appeals under 28 U.S.C. § 1291 and the collateral right doctrine enunciated by this Court in *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541 (1949) (R249a).

Respondents thereupon moved to dismiss the appeals. One panel of the Court decided that they should be fully heard and referred the motion to the panel which would hear the merits. On May 24, 1974, after the merits of appeals were fully briefed and argued, that panel, consisting of Judge Mansfield and Judge Timbers of the Court of Appeals and Judge Davis of the Court of Claims dismissed the appeals for lack of appellate jurisdiction in a per

curiam opinion. Thereafter on August 6, 1974, the Court denied timely motions for rehearing and suggestions for rehearing en banc.

After petitioners had called the failure to serve the independent directors to the district court's attention and while petitioners were perfecting their appeals, the independent directors were served with process by respondent Papilsky approximately 21 months, and by respondent Levine approximately 12 months, after their respective complaints were filed. Before the appeal was perfected Judge Tyler granted motions to dismiss as to these directors on the ground that the delay in serving them constituted a failure to prosecute. In deciding these motions, Judge Tyler considered the "anomalous" situation caused with respect to petitioners' earlier motion by his dismissal of the independent directors whose presence as defendants he had relied upon in denying petitioners' motions and which he regarded as a "virtual prerequisite" to continuation of the case against petitioners. He decided nevertheless to adhere to his earlier ruling (R247a, A-53). In one of these later opinions Judge Tyler also confirmed that in reaching his earlier decision he had not considered petitioners' affidavits submitted in support of the original motion by stating that at that time he was "ignorant of the fact that" the independent directors had not been served (A-53), a fact set out in the original affidavit (R43a), emphasized in a supporting memorandum and discussed in an opposing memorandum.

REASONS FOR GRANTING THE WRIT

The writ should be granted because:

(1) The Court of Appeals' decision is in conflict with the collateral right doctrine established in this Court's decision in *Cohen* v. *Beneficial Industrial Loan Corp.;*

(2) The Court of Appeals' decision is in conflict with the business judgment aspect of the director demand requirement which was established in other decisions of this Court and of other courts of appeals, is embodied in Rule 23.1 and is an important safeguard against abuse in derivative actions; and

(3) The Court of Appeals refused to review the merits of an erroneous district court decision which is in conflict with the decision of another Court of Appeals and which needs to be corrected by this Court now to avoid abuse of the judicial process in shareholder derivative cases.

I. The Conflict With the Collateral Right Doctrine Established in Cohen v. Beneficial Industrial Loan Corp.

The right which petitioners sought to protect in their appeals below and seek to protect here is the right of the corporation—the right of the vast majority of Fund's shareholders—not to have Fund involved in what the independent directors regard as unwise litigation. The Court of Appeals held that this right is not worthy of appellate review before trial. This is directly contrary to this Court's decision in *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541 (1949), where this Court held that this very right is indeed entitled to such protection.

Cohen was a derivative action based on diversity of citizenship brought in a federal court in New Jersey. That state had a statute providing that a shareholder whose shares were worth less than $50,000 or constituted less than 5% of the corporation's outstanding stock could be required in a derivative action to post a bond to cover the corporation's legal expenses.

The district judge held that the statute would not apply in a diversity case and denied a motion for an order requiring that such a bond be posted. Defendants immediately appealed to the Court of Appeals for the Third Circuit, which reversed, holding that the district court's order was appealable and that the statute applied in diversity cases. This Court affirmed on the ground that the corporation's right to protection under the statute was collateral to the merits of the controversy and that the corporation should be permitted an immediate appeal because the value of the

right would be lost if appellate review was postponed until after the trial of the derivative case.

This decision is significant because the only right protected by that appeal was the nominal defendant's right not to bear the expense of the derivative litigation. The Court's decision on the merits shows why the right was accorded such importance. The Court noted that, despite the value of derivative actions in some circumstances, in others they can be nothing but "strike suits" which benefit only the attorneys who bring them at the expense of the vast majority of the shareholders who presumably do not favor the suit. See 337 U.S. at 548. Consequently substantial questions of standing collateral to the merits of the alleged corporate cause of action should be resolved before trial, even to the point of an appeal. If the appeal awaits the trial, the expenses will have been paid and it will be too late to get them back.

The same corporate right is involved in the present cases. Here there is serious doubt that the minority shareholders have standing to maintain the action because the duly elected independent directors, and presumably the vast majority of Fund's shareholders who speak through them, are against the suit. An appeal should have been permitted by the Court of Appeals so that this intra-corporate matter could be resolved before Fund bears the expense of litigating the merits. Indeed, if anything, the aspect of the right protected in *Cohen* which could be avoided merely by rounding up a few additional shareholders was of less significance than the aspect involved here which cannot be so easily circumvented.

In the present cases the possible harm to Fund of delaying the appeals until after trial is not confined to litigation expenses. A trial can cause Fund other harm such as diversion of executive time and energy from managing its portfolio, harmful publicity and other unpredictable con-

sequences which can result whenever anyone brings litigation unwisely.

The Court of Appeals attempted to justify its dismissal of petitioners' appeal by asserting that Fund's right in this case could be vindicated after trial. But the court below failed to explain how the harm could be corrected on a later appeal. The fact is that the harm could never be undone because the expense and other disadvantages would have already been incurred and might exceed substantially any benefits of the lawsuit even if respondents were to prevail.

Moreover the assertion that the error could be corrected at the trial assumes that there is some realistic way in which the corporation, a nominal defendant, could raise the point at such time. However, if the real defendants win at trial, the corporation would not then have standing to appeal on the ground that the suit should not have been brought. On the other hand, if plaintiffs win, the corporation would hardly be in a position to appeal from that result. Therefore, there is no practical way for the corporation ever to be heard in a court of appeals except before trial.

The Court of Appeals attempted to justify its dismissal by labeling petitioners' appeal as from "an order denying a motion addressed to the pleadings" and by stating that there was no precedent for permitting such an appeal before trial. However, this reasoning is untenable because what governs appealability is not the label put on the motion but the nature of the right sought to be vindicated. Under the collateral order rule the *right* sought to be vindicated in the present cases is entitled to immediate appellate protection.

The current vitality of the *Cohen* rule was confirmed only last term by this Court's decision in *Eisen* v. *Carlisle & Jacquelin*, 42 U.S.L.W. 4804 (May 28, 1974), in which this Court held that an interlocutory order requiring a

defendant to spend approximately twenty thousand dollars to cover the cost of class action notices was appealable as of right as a final order. In the present cases the cost to the nominal defendant of being required to go on with these cases will be many times that amount.

Any concern that allowing appeals in these cases would undermine the usual rule against interlocutory appeals would be misplaced. In *Cohen* this Court carefully noted that every order fixing security would not necessarily be immediately appealable by pointing out that it was dealing with a "serious and unsettled" question about the existence of a corporate right and suggested that routine orders about the exact parameters of the right or its precise application in different factual situations might not be immediately appealable:

> "Here it is the right to security that presents a serious and unsettled question. If the right were admitted or clear and the order involved only an exercise of discretion as to the amount of security, a matter the statute makes subject to reconsideration from time to time, appealability would present a different question." 337 U.S. at 547.

The present cases also involve serious and unsettled questions affecting the very existence of the corporation's right not to sue, the same right to which protection was given by the statute applied in the *Cohen* case. The District Court refused even to look at admissions demonstrating that respondents had no standing to force the corporation to bring the action against the wishes of its duly elected independent directors. The basic and unsettled question is whether a district court should consider this corporate right at the outset of the case and how it should proceed.

Nor can there be any doubt as to the importance of this question. The abuse of derivative actions is likely

to increase and with it the workload of the courts if the district courts do not at the outset regularly examine the alleged grounds for disqualifying the directors and to the extent possible weed out those cases where no proper grounds for bypassing them exist. Certiorari should be granted because of the conflict between the decision of the Court below and this Court's decision in *Cohen* and the importance of the question involved.

II. The Conflict With the Business Judgment Aspect of the Director Demand Rule Which Was Established in Other Decisions of This Court and of Other Courts of Appeals, is Embodied in Rule 23.1 and is an Important Safeguard Against Abuse of Derivative Actions.

The per curiam opinion below shows that the Court of Appeals completely misunderstood the thrust of the director demand requirements of Rule 23.1 and the business judgment aspect of this requirement. It held that the director demand requirement is unimportant on the theory that all that is necessary to cure a failure to comply with Rule 23.1 is to make a demand and then to reinstitute the action with a new complaint which alleges that the demand has been made and denied. The Court reached the startling conclusion that in such event the directors' refusal to go along with the demand is of no consequence. This conclusion is embodied in the Court's assertion, which was not supported by any authority, that the corporate right is not of great magnitude because

> "... if (as might well be anticipated) a majority of the board refuses to sue, plaintiffs presumably would then be permitted to reinstate their present actions ..." (A-45)

This holding amounts to nothing less than an overruling of the business judgment aspect of the director demand rule which has been consistently followed by other Courts of Appeals and by this Court and which is embodied in Rule 23.1 Fed. R. Civ. P.

Pursuant to this rule the directors of a corporation, rather than its minority shareholders, manage the corporation and decide whether a suit should be brought on behalf of the corporation. Courts do not interfere with such decisions except where the directors are disqualified from making them because of self-interest, or otherwise. Where the directors are not disqualified the director demand rule is meaningless unless the directors' decision not to bring the case is final and bars the shareholder from proceeding. As Mr. Justice Brandeis said in *United Copper Securities Co.* v. *Amalgamated Cooper Co.*, 244 U.S. 261, 263-64 (1917), in which the Court affirmed the dismissal of a derivative complaint which alleged the making of a demand to directors and their rejection thereof:

> "Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment: . . ."

See also *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903), and the oft-cited concurring opinion of Mr. Justice Brandeis in *Ashwander* v. *Tennessee Valley Authority*, 297 U.S. 288, 343 (1936).

In *Swanson* v. *Traer*, 249 F.2d 854, 858-59 (7th Cir. 1957), another Court of Appeals held:

> "It is obvious that the requirement that a stockholder, before filing a derivative action on behalf of his corporation, must first demand of its board of directors that it cause such an action to be instituted,

> does not mean that the board's refusal on demand to act, *ipso facto,* clears the way for a suit by the demanding stockholder on behalf of the corporation. If it were so, the making of the demand would become a meaningless mechanical operation. . . .
>
> "*A corporation's right not to sue is correlative to its right to sue.* Unless an equitable basis for intervention be shown, an individual stockholder has no more right to challenge by a derivative suit a decision by the board of directors not to sue than to so challenge any other decision by the board." (emphasis added)

More recently the rule was followed in *In Re Kauffman Mutual Fund Actions,* 479 F.2d 257, (1st Cir.), *cert. denied,* 414 U.S. 857 (1973).

The rule applies even where the directors participated or acquiesced in the decision complained of. They may not be bypassed so long as they are not self-interested in the particular transaction. *In Re Kauffman Mutual Fund Actions, supra* at p. 265, *Ash* v. *IBM,* 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied,* 384 U.S. 927 (1966), *Wachsman* v. *Tobacco Products Corporation of New Jersey,* 129 F.2d 815, 817-818 (3d Cir. 1942), *Lucking* v. *Delano,* 117 F.2d 159 (6th Cir. 1941), and *Long* v. *Stites,* 88 F.2d 554 (6th Cir. 1937); see also *Issner* v. *Aldrich,* 254 F. Supp. 696 (D. Del. 1966). We know of no cases other than the opinion below in which this rule has been rejected.

Prior to the decision below, the business judgment aspect of the director demand rule was so well established that it is embodied in the second sentence of Rule 23.1 Fed. R. Civ. P. which requires that a derivative plaintiff plead with particularity that he has attempted to prevail upon the directors to take the action he desires or to explain his reasons for failing to make the effort. An important purpose of this provision is to insure that the court will be able to determine whether plaintiff has a sound basis for disqualify-

ing the directors and for claiming that he rather than the directors should decide whether the corporation sues.

The business judgment aspect of the rule is of great importance in derivative actions because if it were abolished many more business decisions could be challenged in derivative actions than is now the case. A court of appeals should not be permitted to abolish this important safeguard against improper derivative actions by in effect asserting that "presumably" it does not exist.

III. The Court of Appeals Refused to Review the Merits of an Erroneous District Court Decision Which is in Conflict With the Decision of Another Court of Appeals and Which Needs to be Corrected Now By This Court to Avoid Abuses in Shareholder Derivative Cases.

If the director demand rule is to have any vitality, it is important that immediate action be taken by the district court whenever it appears that a derivative plaintiff may not have "good ground" for alleging or "reasonable basis" for swearing that the independent directors are disqualified, and that the complaint be dismissed at once where no such basis is found to exist. If such prompt action is not taken, the courts will find themselves continuing many derivative cases which the directors wisely and properly decided should not have been brought because they lacked merit or were likely to do more harm than good to their corporations. The derivative action, which was designed to help corporations, will be used to their detriment.

The tools for prompt action are readily at hand. Rule 11 provides that an attorney must have "good ground" for pleading any allegation and that a pleading signed with intent to defeat the purpose of that rule may be stricken as sham and frivolous (A-2). Rule 23.1. provides that all

complaints in derivative actions must "be verified" which, as this Court has indicated, means the allegations must be grounded upon "reasonable belief" " based upon careful investigation." *Surowitz* v. *Hilton Hotels Corp.*, 383 U.S. 363, 373 (1966). Rule 23.1 also provides that the reasons for not making the effort to obtain action from the directors, unlike other allegations in notice pleadings, must be pleaded "with particularity." (A-3). Rule 41(b) provides that any action may be dismissed for failure of the plaintiff to comply with the Rules.

In the present case, the district court erroneously refused to use the available tools. The fact that the allegations of domination and control failed to meet the particularity requirement of Rule 23.1 (itself a ground upon which the complaint should have been dismissed) was a strong indication that they were unfounded. Petitioners' deliberate failure to serve process upon or to prosecute the alleged case against the independent directors similarly suggested that the naming of them as defendants was not supported by any evidence.

These indications were confirmed by the deposition of counsel for one of the respondents, who admitted that he had all the evidence available to his side and whose considered and deliberate testimony, together with the documents referred to therein, was shown to amount in effect to clear admissions that there was no good ground or reasonable basis for the attack on the independent directors (R77a).

When petitioner presented these facts in an affidavit which was not contradicted by respondents, who filed no counter-affidavits or other evidence that they in fact had such good ground or reasonable belief, that court refused even to consider the affidavit. By so doing it made mockeries of the good ground requirement of Rule 11, the verification requirement of Rule 23.1 and the particularity and director demand requirements of the same Rule. It also failed to heed the statutory scheme whereby the independent directors are supposed to regulate relationships

with the adviser or the statutory presumption that the independent directors are not controlled* and rode roughshod over the rights of the majority of Fund's shareholders, who are represented by their duly elected independent directors, who in turn believe that Fund's best interest lies in not bringing these cases.

The Court of Appeals for the First Circuit recognized the error of the district court in *In Re Kauffman Mutual Fund Actions, supra,* where its holding was directly contrary to that of the district court in the instant cases. It dismissed a derivative action brought on behalf of mutual funds against their respective advisers where the complaint contained generalized allegations of domination and control similar to those in the instant cases. In so doing it went out of its way to state as follows in a footnote its inability to distinguish the present cases and its belief that the authorities cited by the district court did not support its decision:

> "We cannot similarly distinguish the recent case of *Papilsky* v. *Berndt,* S.D.N.Y. 59 F.R.D. 2d 95. We do, however, note that the authorities cited do not, in fact, support the decision. . . ." 479 F. 2d at p. 266 n. 6.

Kauffman was recently followed by the Appellate Division of the New York Supreme Court in *Greenspun* v. *Lindley,* 44 A.D.2d 20, 352 N.Y.S.2d 633 (1st Dep't 1974).

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* Section 2(a)(9) of the Investment Company Act provides:

"A natural person shall be presumed not to be a controlled person within the meaning of this subchapter. Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person. If an application filed hereunder is not granted or denied by the Commission within sixty days after filing thereof, the determination sought by the application shall be deemed to have been temporarily granted pending final determination of the Commission thereon." 15 U.S.C. 80a-2(a)(9), (1970).

This statute suggests that the remedy of a shareholder who believes that independent directors are controlled by an adviser is to be found, at least in the first instance, in the Commission rather than in the courts.

Judge Gurfein also recently expressed views contrary to those of Judge Tyler as follows:

> "This complaint has a bold and expansive thrust. It attempts to solve the problem of the specificity of demand under Rule 23.1, in the case of mutual funds by a simple device. It simply sues everybody, including the unaffiliated directors. The plaintiff then "boot-straps" the argument, by asserting with an air of injured innocence, that since she is suing the unaffiliated directors as well, how can she be expected to go to them for relief? Aside from the circumstance that she has not served any of the directors, save one, I cannot agree that the mere naming of an unaffiliated director, who is charged with approving a challenged transaction, create an irrebuttable presumption that he would not entertain a claim for relief against others. It is not for the plaintiff herself to build a wall around the unaffiliated director of a mutual fund, and then tell him he cannot jump over it." *Phillips* v. *Bradford*, 62 F.R.D. 681, 688 (S.D.N.Y., 1974).

At the argument in the cases at bar the district judge seemed to accept the view that membership in the bar is a license to bring any derivative action and assert any factual allegation, and that if the allegations state a cause of action the plaintiff gets full discovery and a trial no matter how spurious or speculative the allegations may be or the extent to which essential prerequisites to maintaining the action may be ignored. (A-29) But this is certainly not the intent of the Federal Rules.

The integrity of the judicial process in derivative cases requires that such notions be corrected at once and that prompt action be taken where a conclusive showing is made that essential allegations are sham and false or were not properly verified. Since neither of the courts below performed this function in the present cases, it is now necessary for this Court to step in.

CONCLUSION

For the foregoing reasons the writ should be granted.

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Respectfully submitted,

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